

## Nonprofit Organizations and the Market-Hierarchy-Continuum: A research sketch

*Economics of Nonprofit Organizations; Governance Mechanisms; Market-Hierarchy-Continuum; Transaction Cost Theory*

*Some works in recent literature on the economics of nonprofit organizations deny the applicability of Williamson's market-hierarchy-paradigm to the nonprofit sector. This paper aims to present arguments for the opposite hypothesis and thereby deepen the debate on an adequate economic theory for nonprofit organizations. It is based on the transaction cost theory and outlines three ideas that argue for an institutional analysis of nonprofit organizations by distinguishing them through their specific and individual governance mechanisms. Pursuing these ideas, contributions to further nonprofit economic research might become possible.*

### I. Introduction

Within economic theory, the “economics of governance” and New Institutional Economics (Williamson 1991 a; b; 1996; 2010) related to nonprofit organizations are a fringe area that very few scientists have dealt with (Dyl/Frant/Stephenson 2000; Eldenburg et al. 2000; Krashinsky 2003; Valentinov 2009 b; Jegers 2009). Speckbacher (2008, p. 295) stated that „research-based analysis of governance mechanisms in nonprofit organizations is relatively underdeveloped“. In recent years, a certain line of argument has been developed stating that the transaction cost theory is not applicable to nonprofit organizations as its institutional governance mechanisms only concern the for-profit, and not the nonprofit, sector (Valentinov 2009 a; 2009 b). According to Valentinov (2009 a, p. 5), it is “evident” that the market-hierarchy-continuum explains governance mechanisms within the for-profit sector only.

Instead, Valentinov gives a different understanding of transaction costs applied to the third sector: they should not be seen as a reason of choice within the market-hierarchy-continuum, but as a constraint on the division of labor. This constraint draws the line between preferences that can be satisfied by exchange via market mechanisms, and those that can be gratified by self-sufficiency only. For the former – based on market exchange – for-profit firms emerge. For the latter – when transaction costs cannot be economized by a special kind of division of labor – institutions of self-sufficiency arise. Hence, nonprofit organizations should be excluded from the market-hierarchy-paradigm.

However, this evidence appears to be disputable. Transaction cost theory may have limitations regarding the analysis of nonprofit organizations. Krashinsky (1997) outlined that nonprofit organizations might come into existence because government favors private nonprofit organizations in some cases (e. g. research studies about how much hospital care is needed or studies about

nuclear power), although transaction costs could be lower in alternative organizational institutions. Furthermore, one has to take into account that statutory conditions which privilege nonprofit organizations in some respect, can be another factor promoting the existence of nonprofit organizations despite their transaction costs (Rose-Ackerman 1996, p. 718). Differences between American and European nonprofit organizations support these arguments (see Theuvsen 1999, p. 230).

This paper provides evidence and, consequently, argues for the applicability of transaction cost theory to nonprofit organizations. Williamson, who originally elaborated the continuum of different institutional governance mechanisms, spoke explicitly about “nonprofits” when describing different governance structures (Williamson 2000, p. 599). He discussed the institutional arrangement of trade unions (Williamson 1991 b), which are generally acknowledged as nonprofit organizations (von Schnurbein 2009). Building on transactions as the basic unit of analysis and transaction costs – as “costs of running the economic system” (Arrow 1983, p. 134), Williamson showed no reluctance in analyzing a nonprofit organization by means of the transaction cost analysis. The focus of his analysis is on efficiency and operational capability (Williamson 1991 a, p. 17) that becomes possible through an adequate handling of transaction costs. This may serve profit maximization, or just as well any other defined objective. Furthermore, redrafted profit maximization goals, such as cost recovery or loss limit objectives, also count in nonprofit organizations and are conducive to their continued existence (Theuvsen 1999). Why then should the rationale of economizing transaction costs not be relevant in reaching typical goals of nonprofit organizations such as output maximization or quality maximization of nonprofit organizations (Badelt 1997)?

Defending an institutional analysis of nonprofit organizations, this paper argues that nonprofit organizations should be considered as organizational alternatives next to markets, government, and for-profit organizations that do not come into existence only when the latter fail (see also Krashinsky 1986, p. 114 f.). As it is systematically applicable, New Institutional Economics form a valuable instrument that should not be excluded from nonprofit economic theories. Transaction cost theory as one element of New Institutional Economics provides a universal analytical pattern for comparative economic analysis of different governance mechanisms and helps in explaining why certain organizational governance forms outweigh others because of lower transaction costs. However, it is still a challenging research task to build a systematic, comprehensible, and application-oriented characterization of the huge variety of nonprofit organizations. Transaction cost theory might help in revealing this “black box” (Williamson 2005, p. 4) of the inner workings of nonprofit organizations as outlined below.

## II. Three Ideas

### 1. Can different nonprofit types be assigned to different places within the continuum?

Building on Williamson (1979; 1980), Picot (1982) enumerates three main characteristics of governance mechanisms to describe institutions within the market-hierarchy-continuum: a) property

rights of transaction-relevant resources (independent versus fused), b) assignment of the transaction's success to the transaction partners (individual versus pooled), and c) subjection to directives (from (nearly) none to (nearly) complete). Accordingly, the question is not which transaction should be accomplished through a market, hybrid, or hierarchy governance system, but how much of each system is contained in one transaction (Picot 1982, p. 275, Bonus 1986). Building on these three criteria, different institutional forms of nonprofit organizations can be classified: A self-sufficient nonprofit organization for example can be classified with a) independent property rights as every member holds the property rights of the resources needed to produce the transaction relevant goods, b) a hybrid success attribution, as the success of production belongs to the holder of the resources, whereas the success of utilization may lie within the group when pooled consumption of outputs is envisaged, and c) a certain subjection to directives, as the allocation of goods to be consumed by the members of the self-sufficient organization must be institutionalized (Williamson 1985, p. 17). A foundation with focus on research funding can be seen as an institution with a) merged property rights, b) pooled success attribution, and c) no or little subjection to directives.

To sum up, apart from the rather unrealistic model of individual autarky, any form of economic transaction is based on an institutional arrangement (see Commons 1932) and requires a governance system as it helps to maintain order, mitigate conflicts and achieve mutual gains (Williamson 2005, p. 5). Consequently, there is no reason why nonprofit organizations should not be seen as variations of "nonstandard modes of contracting" (Williamson 1985, p. 19) to economize transaction costs and why nonprofit organizations should not fit into the analytical framework of the traditional transaction cost theory.

However, comparing self-sufficiency organizations for example to unions or major foundations illustrates the great heterogeneity within the nonprofit sector. Moreover, there is empirical evidence of industries in which for-profit and nonprofit organizations offer the same services, for example, nursing home industries, child day care, or health insurance (Hansmann 1996; Rose-Ackerman 1996 with reference to studies of e. g. Kagan 1991, Hawes/Phillips 1986). Likewise, there are also branches where established services have been originally offered by nonprofit organizations (Badelt 1997). Thus, there seems to be no clear frontier between nonprofit and for-profit branches, but rather mixed industries where nonprofit, for-profit and governmental organizations compete with each other (see also Hansmann 1996, p. 5). They are all diverse forms of institutional arrangements to cope with the costs of transactions (Krashinsky 1986). Therefore, transaction costs are not seen as 'brute facts' that cannot be altered by using any governance mechanism" (Valentinov 2009 a, p. 7), because if they were non-influenceable, economic analysis would become superfluous. This paper agrees with Williamson who argued that there is an economic rationale for different organizational forms of transactions (Williamson 1985, p. 52) and that there are mechanisms to alter the costs of the transaction in focus. Which mechanism fits best depends on the transaction's characteristics. They are described within the transaction theory by different principal dimensions. These are asset specificity, uncertainty, and frequency, the latter often comprising the transaction atmosphere additionally (Williamson 1985, p. 60). The atmosphere covers all sociocultural and technical factors that influence the transaction costs of different governance mechanisms in given circumstances (Picot/Dietl/Franck 2005, p. 61). Regarding transaction atmosphere or frequency, Williamson took into consideration, *inter alia*, market size

and its number of actors (Williamson 1985, p. 60) as they lead to characteristics that influence transaction costs (for a good example see Bonus 1986, p. 316ff.).

With the help of these dimensions, distinctive characteristics of transactions and thus specified transaction costs can be defined, and the adequacy of different governance mechanisms can be derived. A very transaction specific investment for example will create high transaction costs for drafting, negotiating, and safeguarding the transaction agreement (Williamson 1985, p. 20). Accompanied by severe information problems, a classical contract following market governance structures will not be able to capture this specific transaction (Williamson 1985, p. 73): with respect to high specific investments, not a standardized, but a specialized governance structure becomes necessary. Hence, subject to the dimensions of transactions, different governance structures are superior to others. A discrete comparative analysis of the related transaction dimensions can explain different forms of organizational institutionalizations as well as nonprofit organizations. The transaction cost theory depicts a consistent framework of different mechanisms that can be applied to all existing types of organizations. With its help, a “discrete structural analysis” (Williamson 1991 a, p. 270) becomes possible allowing the comparison between different forms of institutionalization.

In the literature, there are three major strands that analyze under which circumstances a nonprofit institution might prevail over other institutional arrangements (Krashinsky 2003, p. 28, referring to the theories of Weisbrod 1975, James 1987, and Hansmann 1987). However, they do not provide an answer to the question why nonprofit organizations develop in different institutional forms (Toepler/Anheier 2005). That is why the first idea is to start closing this research gap by analyzing the different sets of governance structures of various nonprofit organizations (see also the works of Bonus 1986; Valentinov/Fritzsch 2007; Speckbacher 2008; Iliopoulos/Valentinov 2010 for deeper analyses of various nonprofit forms). By disclosing their different arrangements of governance elements systematically, the different types of nonprofit organizations might become assignable to certain places within the market-hierarchy-continuum as is illustrated in Figure 1.

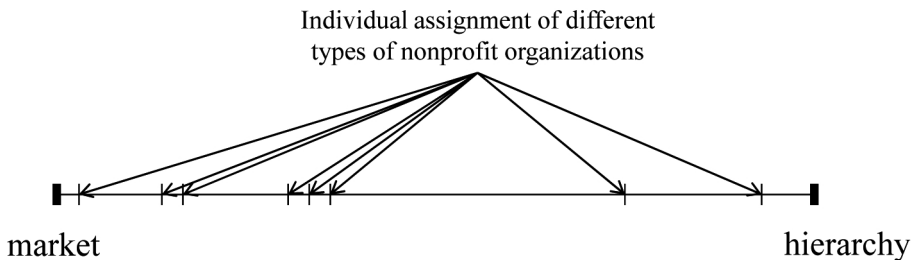


Figure 1: Assignment of organizational types to the market-hierarchy-continuum

Source: Author's own diagram.

Research hypothesis 1 reads hence as follows: *Each type of nonprofit organization can be described by a certain set of governance mechanisms and has therefore a definable place within the market-hierarchy-continuum.*

## 2. Is an enhancement of the continuum possible?

As institutions focus on various targets, it might be interesting to examine whether the one-dimensional framework could be broadened by another dimension relating to the different organizational goals as illustrated in Figure 2. A reasonable systematization and scaling of the organizations' goals would be the first necessary step. However, considering the "law of complexity" (Anheier 2005, p. 229) regarding the numerous bottom lines of nonprofit organizations, this will be non-trivial. It must, therefore, be analyzed whether the content objective of outcome maximization could be seen as an aggregating bottom line of nonprofit organizations the same way as the price and the formal goal of profit maximization for for-profit organizations. Based on these two poles (outcome versus profit maximization), the possibility of having the subordinate goals allocated between them needs to be checked. The developed classification of different types of nonprofit organizations by Saxe (2009, page 14ff.) might be a promising starting point, differentiating in the three criteria 1) kind of contribution (benevolent vs. equivalent), 2) kind of help (inside help vs. outside help), and 3) kind of social good (intermediate vs. finally).

If the second dimension should prove to be adjustable to the market-hierarchy-continuum, the classification of different types of nonprofit organizations could be further developed as illustrated in Figure 2 and two further research hypotheses could be derived:

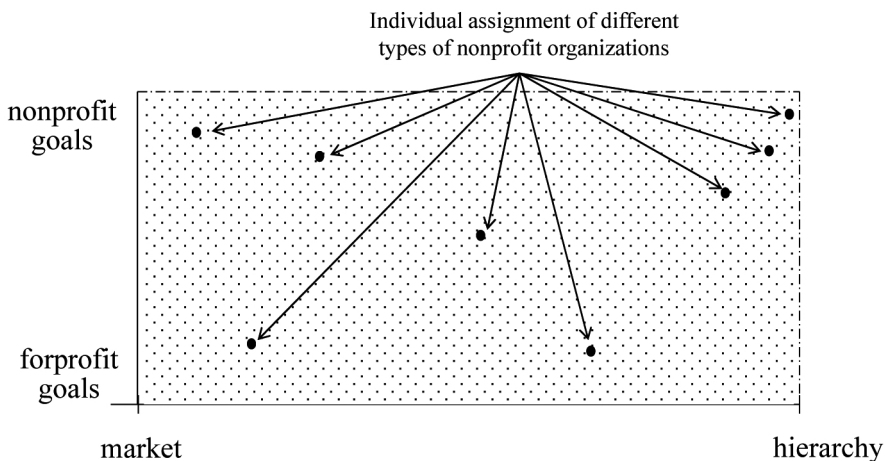


Figure 2: Possible broadening of the market-hierarchy-continuum

Source: Author's own diagram.

Research hypothesis 2 a: *There is a continuum between profit and outcome maximization that is adjustable to the market-hierarchy-paradigm.*

Research hypothesis 2 b: *Within the enlarged continuum, individual assignment of different types of nonprofit (and for-profit) organizations becomes possible.*

### 3. Is there a second “move-to-the-middle”-trend?

By doing so, it may be also examined whether a second “move to the middle”-hypothesis can be derived. Originally developed by Clemons, Reddi, and Row (1993), it describes the trend to hybrid organizational forms that have been discovered for several years now in the for-profit and non-profit sector (see also Williamson 1991 a; 1996; 2010 and Ménard 2004). As all nonprofit organizations are confronted with a more competitive environment and resource shortages (Jäger/Beyes 2010), the need for a more professional organizational management is often discussed in the nonprofit literature (Helmig/Jegers/Lapsley 2004; Beck/Lengnick-Hall/Lengnick-Hall 2008; Carman 2010). At the same time, goals next to profit maximization such as sustainability and corporate social responsibility become more and more important for for-profit organizations. Concerning their focuses and goals, it also needs to be analyzed whether for-profit and nonprofit organizations are converging by moving to the middle as illustrated in Figure 3.

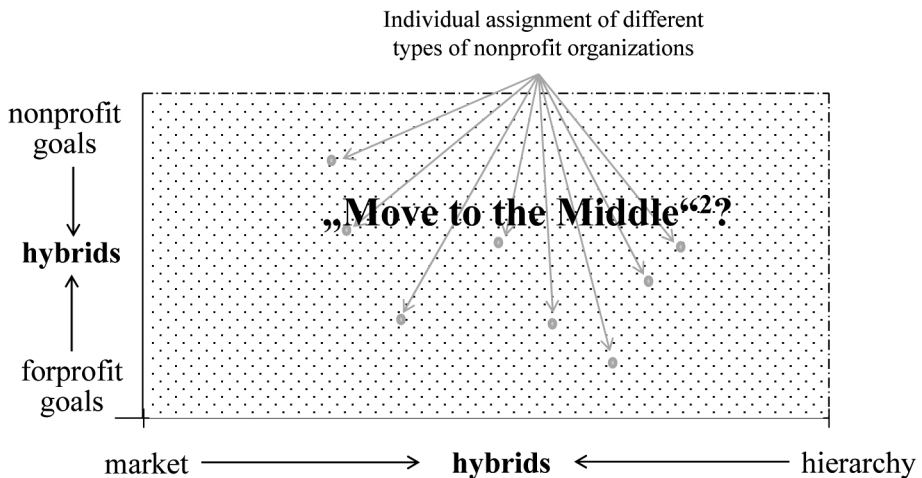


Figure 3: Is there a second “move-to-the-middle”-trend?

Source: Author's own diagram.

Research hypothesis 3 hence reads: *Within the enlarged market-hierarchy-continuum, for-profit and nonprofit organizations are approaching each other.*

Eventually, if the three ideas lead to theoretical conclusions, they are to be tested empirically by contrasting the (enlarged) raster with different forms of actual nonprofit organizations.

## III. Conclusion

The aim of this paper is to outline a research sketch about an enhancement of nonprofit institutional theory. Using the economic raster developed by Williamson, a systematic disclosure of the ef-

fective incentive and governance mechanisms of each nonprofit organization is aimed for. As a result, a systematic list of different incentive and governance regimes of nonprofit organizations can be expected. With the aid of the institutional-choice approach, a comparison of different nonprofit organizations is possible and an approach to explain the emerging different forms of nonprofit organizations seems to be feasible. Based on an institutional-choice analysis, new inputs are aimed for, showing which criteria can explain the emergence of different types of nonprofit organizations. Furthermore, it needs to be analyzed whether a second dimension could be integrated in the market-hierarchy-continuum concerning the different bottom lines of nonprofit and for-profit organizations. Additionally, it seems to be worthwhile to test whether a second “move-to-the-middle” trend can be observed as nonprofit and for-profit organizations are increasingly including formal goals and content objectives respectively in their specific bottom lines.

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